UK finance needs radical reform to upgrade the post-Brexit economy

*Although recent attention has been on the quantity of UK finance post-Brexit, its quality will be every bit as important, writes **Alfie Stirling**. He explains some of the key problems with the UK's financial market sector, and offers suggestions on how to improve the flow of capital to businesses most in need of investment, and how to promote long-term investment.*

At a recent event marking the 10-year anniversary of the financial crisis, the Governor of the Bank of England Mark Carney said the UK's banking sector could be "15 to 20 times GDP" in just a "quarter of a century". But such proclamations beg a big question: what is the value of all this activity and wealth to the rest of the economy?

In terms of business success – share of employment, profits, tax contribution, and exports – UK finance is world beating. Progress is also being made to tackle systemic risk, with new Basel III capital buffers set to be fully implemented by 2018, although these will remain truly untested until the next crisis comes along.

But what about the role of finance in supporting investment in the rest of the economy? This was the question asked by the latest discussion paper for the IPPR Commission on Economic Justice – a new initiative launched in November 2016, bringing together leading figures from across business, trade unions, civil society, and academia to examine the challenges facing the UK economy and make practical recommendations for reform.

After all, the primary occupation of finance is to move money from savers (including through money creation) to investors in order to optimise the use of resources across the economy. Yet despite having one of the largest finance sectors in the world, spending on fixed capital, along with research and development, is well behind in the UK compared with the rest of Northern Europe and the Unites States.

Finance markets contribute to investment through two key mechanisms: first, on the supply side, they ensure that finance flows to firms that are otherwise unable to fund projects internally; second, on the demand side, it intermediates the ownership of company shares on the stock exchange. Many listed companies will be able to pay for investment internally from profits, but as a system, financial markets can set the incentives for corporate boards and therefore the general appetite for investment overall.

A striking observation is that whether or not finance is doing a good job on either the demand or the supply side in the UK, it is certainly doing it expensively. As the works of Thomas Philippon and Guillaume Bazot have shown, the unit cost of intermediation to the non-financial economy is higher now than it was in the 1950s – a remarkable occurrence given that almost immeasurable advances in information, including computer chips, the internet and mobile telephony over this period.


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New IPPR analysis also suggests that in recent years, the UK has been an outlier among advanced economies in not seeing productivity gains in finance passed on in prices to the rest of the economy. Unfortunately, particularly given that UK finance remains so expensive, the quality of support for investment from finance markets also appears to be wanting.

On the supply side, and beneath the often-cited recovery in aggregate lending to small and medium enterprises since 2014, we find that the recovery has been almost entirely driven by lending to medium-sized firms only. Lending to small companies has been negative in all but one quarter over the last three years. This is unlikely to change without intervention. UK's banks are particularly inclined to invest in property rather than business, with the ratio between real estate loans and business loans three times higher in the UK compared with the euro zone average. And new safety requirements since the crash also make it harder for banks to lend to firms without traditional collateral – precisely those that are currently most in need of credit.

On the demand side, short-term pressures in equity markets are passed through to company board rooms, leading to an excessive focus on share price, rather than the fundamental value of a firm. For example, a survey of more than 400 executives found that 75% would sacrifice positive economic outcomes if it helped smooth short-term earnings. The incentives for long-term investment by companies, therefore, are often frighteningly weak given the interests of consumers who want falling prices; employees who want higher pay; and savers who require a reliable long-term return for their pensions.

The answer is a radical reshape in the way finance supports investment. On the supply side, IPPR proposes that the Bank of England further reduces the relative cost of lending specifically to small businesses within small and medium enterprises (possibly through the Funding for Lending Scheme). The government (possibly through the British Business Bank) should also support markets to use intellectual property as an alternative form of collateral.

Most importantly, a fleet of new specialist investment banks should be created – either from parts of RBS itself or from the sale of its publicly owned shares. Respective banks should have a public mandate to invest only in a certain sectors or certain geographies of the country, fostering the expertise needed to extend credit to particular types of young, fast-growing firms and crowding in private investment in the process.

On the demand side, a blend of tax and legal reform is needed to realign incentives in stock markets with the long-term interest of the savers who own company shares. The legal responsibility to ultimate share owners – the fiduciary duty – should also be extended to asset managers and brokers and a new Responsible Ownership Commission should be established to help intermediaries interpret and comply with their new responsibilities.

In addition, IPPR calls for government to scrap the 'market maker' relief on Stamp Duty Reserve Tax – a Stamp Duty of 0.5% on the purchase of company shares – which currently exempts almost half of all transactions altogether. This would reduce incentives for rapid trading and raise around £1.2bn per year by 2020 which could be used for alternative reliefs in capital gains tax and corporation tax to incentivise longer term ownership of company shares.

While finance is far from the only area of the economy in need of reform (with other discussion papers from the Commission on Economic Justice on industrial strategy, labour markets and corporate governance either published or forthcoming) such reforms are needed to upgrade the UK to a higher investment, higher productivity, and higher paying economy.

Governor Carney has suggested that one of the key concerns facing the UK economy is that the growth of UK finance could be damaged by Brexit. But post-Brexit, the quality of finance will be every bit as important as its quantity – just as it is today.

This article first appeared on the BPP and gives the views of the authors, and not the position of LSE Brexit, nor of the London School of Economics. It draws on an IPPR Commission on Economic Justice paper.

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